

IN THE
Supreme Court of the United States

October Term, 1964

No. **486**

Office Supreme Court, U.S.

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W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, CAROL F. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR. and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH, 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN,

Petitioners-Appellants,

~~HELEN J. GERNON and HELENE G. HERNON as Executrices of the Last Will and Testament of FRANK E. GERNON, Deceased, HELEN J. GERNON,~~

Plaintiffs,

against

THE UNITED STATES OF AMERICA,

Respondent.

**PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT**

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against

THE UNITED STATES OF AMERICA,

Respondent.

**PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT**

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered on June 19, 1964 in the above entitled case.

Opinions Below

The opinion of the United States Court of Appeals for the Second Circuit is not yet reported but is printed in Appendix A hereto, *infra*, pp. 1a to 7a, to this petition. The opinion of the District Court is reported at 224 F. Supp. 358 and is set forth herein in Appendix A hereto, *infra*, pp. 8a to 21a.

Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit was entered on June 19, 1964. The jurisdiction of this court is invoked under Title 28 U.S.C. 1254(1).

Questions Presented

1. Whether under the 1939 Internal Revenue Code gain realized on the sale of notes issued at a discount constitutes capital gain or ordinary income in the nature of interest?

2. Where the petitioners relied, in entering into a transaction, upon a Treasury position, evidenced by a published Commissioner's Acquiescence in a decision of the Sixth Circuit (*Commissioner v. Caulkins*, 144 F. 2d 482 (C.A. 6th, (1944))), that original issue discount is, when realized, capital gain, may the Commissioner thereafter change his position retroactively to the detriment of the petitioners, and seek to tax such income as ordinary income in the nature of interest?

Statutes Involved

The relevant sections of the Internal Revenue Code of 1939 are printed in Appendix A, *infra*, pp. 21a to 22a.

Statement of the Case

Petitioners, members of the firm of Carl M. Loeb, Rhoades & Co., a partnership, instituted this action for the refund of income taxes and interest alleged to have been erroneously and illegally assessed and collected by the Government from them for the year 1952.

During the calendar year 1952, the partnership acquired 33 short-term non-interest bearing promissory notes which had been issued at a discount. The notes were purchased, either directly from the issuing obligor corporation or through agents or dealers, on the original date of issue in all but one instance. The notes had been purchased by the

partnership in reliance on the Commissioner of Internal Revenue's interpretation of applicable Sections of the Internal Revenue Code as evidenced by his published Acquiescence in the case of *Commissioner v. Caulkins*, 144 F. 2d 482 (C.A. 6th, 1944). In that case the Sixth Circuit held that gain realized upon redemption at maturity of a debt obligation issued at a discount is capital gain.

Immediately upon acquisition, the promissory notes were segregated and identified as held for investment in accordance with Section 117 (n) of the Code. From time to time during the year 1952, the partnership sold some of the promissory notes prior to maturity thereof but which had been held by the partnership for a period in excess of six months.

The partnership reported the difference between the sales price and its cost as long term capital gain from the sale of capital assets, and the partners reported their respective distributive shares of said capital gain and paid the tax thereon. The Commissioner disallowed the petitioner's capital gain treatment on the 1952 sale of their promissory notes, and ruled that the profits were ordinary in the nature of interest. The Commissioner computed the income earned by virtue of the discount for each day that each of the 33 notes were held by the Partnership. This earned discount per day was then multiplied by the number of days that the notes were held, and the resulting amount was held ordinary income in the nature of earned interest, and each partner was held taxable on his distributive share of such ordinary income. The deficiencies were paid by the petitioners, claims for refund were filed and denied, and the petitioners thereafter instituted this action in the District Court.

On cross motions for summary judgment, the issues before the District Court were (1) whether the gain attributable to the original issue discount should, under the 1939 Code, be treated when realized as ordinary income or capital gain and (2) whether in light of the consistent prior

Treasury position as evidenced by the Acquiescence in *Commissioner v. Caulkins*, which recognized original issue discount when realized as capital gain, may the Treasury despite petitioners reliance thereon, retroactively change its position to the detriment of petitioners. The District Court granted the Government's motion for summary judgment and dismissed with prejudice the amended complaint of the petitioners. The Court of Appeals affirmed.

Reasons for Granting the Writ

1. The Court below held that gain attributable to original issue discount when realized on the sale of notes issued at a discount constitute ordinary income under the 1939 Code. This decision is in direct conflict with the recent decision of the Sixth Circuit Court of Appeals in *Midland-Ross Corp. v. United States*, No. 15,524, decided July 29, 1964, not yet reported, reprinted in Appendix B, *infra*, pp. 23a to 24a. The conflict was recognized in the opinion of the judges of the Sixth Circuit Court of Appeals, *infra*, at p. 24a.

This conflict was also recognized by the Court below, *infra*, at p. 6a, because of the earlier decision by the Sixth Circuit in *Commissioner v. Caulkins*, which was followed by that Court in *Midland-Ross Corp. v. United States*.

A further conflict has arisen, since the decision below. On July 28, 1964, the Court of Appeals for the First Circuit, passed on the same question, and followed the decision below. *Real Estate Investment Trust of America v. Commissioner*, No. 6288, decided July 28, 1964: A direct conflict, thus exists on this question also as between the First Circuit and the Sixth Circuit.

2. Certiorari should be granted because of the importance of the issues.

A. That portion of the decision below relating to the tax treatment of original issue discount under the 1939 Code is of continued importance in the interpretation and administration of the Internal Revenue Code of 1954. Section 1232 (a) (2) (A) of the 1954 Code treats original issue discount realized on the sale of evidence of indebtedness as ordinary income. However, this section is applicable only to evidences of indebtedness issued after December 31, 1954. The tax treatment of debt instruments issued prior to January 1, 1955, if sold prior to maturity, would be determined by the construction of Sections 61, 1001 (a) and 1221, the successors respectively to Section 22 (a), 111 (a) and 117 (a) (1) of the 1939 Internal Revenue Code, and if held to retirement, determined by the construction of Section 1232 (a) (1), the successor to Section 117 (f) of the 1939 Internal Revenue Code.

Petitioners understand that numerous evidences of indebtedness issued at a discount prior to January 1, 1955 have been retired or sold in taxable years which are still open and under review by the Internal Revenue Service. There may also be numerous debt instruments issued at discount prior to January 1, 1955 which are still outstanding; the tax consequence of which remains yet to be determined. Consequently, it is in the public interest that this Court settle the question as to whether realized profit by reason of original issue discount on debt instruments issued prior to January 1, 1955 is ordinary income or capital gain. In the absence of a decision by this court, litigation involving the tax treatment of original issue discount on debt instruments issued prior to January 1, 1955 will continue and the tax treatment of such original issue discount will depend upon where the taxpayer resides.

B. The aspect of the decision below having to do with the Commissioner's retroactive application of his change of position arising from his repudiation of his prior Acquiescence in *Commissioner v. Caulkins* is of great import-

ance to the entire business community under any Internal Revenue Code. The Court below held that the Commissioner may in 1955 withdraw his 1944 acquiescence in *Commissioner v. Caulkins*. However, the Court below, purporting to follow this Court's decision in *Automobile Club of Michigan v. Commissioner*, 353 U. S. 180 (1957), further held that the Commissioner may without regard to the circumstances of the case successfully and at will impose tax consequences arising from the subsequent change of position upon a transaction entered into and consummated in 1952 in reliance upon the Commissioner's then undisturbed Acquiescence. The Court below moreover approved the retroactive application to petitioners of Commissioner's change of position despite the fact that such change had not been uniformly applied to all taxpayers. See Revenue Ruling 56-299, 1956-1 Cum. Bull. 603. This is no different from retroactive and discriminatory taxation and should be repugnant.

The decision below will harm the orderly administration of the tax laws. First, it is unhealthy for administrative law to approve administrative action imposing taxes not foreseeable by taxpayers. The power of the administrative authority thus sanctioned would verge on the purely arbitrary. Second, the decision greatly impedes business planning. Businessmen, and their tax law advisers, do and should be encouraged to, rely on the law as stated in decisions of the Courts in which the Commissioner announces his Acquiescence. Reliance is invited by the very words of the official bulletin in which an Acquiescence is published. Under the decision below, business planners may no longer rely on the Commissioner's Acquiescences. The decision, unless reviewed by this Court, will hinder and frustrate the planning of business transactions both large and small and therefore the productive functioning of the economy.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari be granted.

September 2, 1964.

Respectfully submitted,

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APPENDIX A

(Opinion of Court of Appeals)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 451—September Term, 1963.

(Argued April 30, 1964

Decided June 19, 1964.)

Docket No. 28752

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR. and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ABELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN,

Plaintiffs-Appellants,

HELEN J. GERNON and HELENE G. HIRSON, as Executrices of the Last Will and Testament of FRANK E. GERNON, Deceased, HELEN J. GERNON,

Plaintiffs,

—v.—

THE UNITED STATES OF AMERICA,

Defendant-Appellee.

Appendix A—Opinion of Court of Appeals

Before:

MOORE, SMITH and KAUFMAN,

Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York, LEVET, J., awarding summary judgment to the United States in an action for the refund of income taxes paid. 224 F. Supp. 358 (S. D. N. Y. 1963).

Affirmed.

BERNARD E. BRANDES, of Stroock & Stroock & Lavan, New York, N. Y. (Sanford Saide-man, of counsel), *for plaintiffs-appellants.*

ROBERT ARUM, Assistant United States Attorney for the Southern District of New York, New York, N. Y. (Robert M. Morgenthau, United States Attorney, of counsel), *for defendant-appellee.*

KAUFMAN, *Circuit Judge:*

The sole question presented by this appeal is whether profits attributable to original issue discount on "commercial paper," defined as short-term, non-interest-bearing commercial obligations, are taxable at ordinary income or capital gains rates under the Internal Revenue Code of 1939.¹

¹ Unlike the 1954 Code, see *infra*, the Internal Revenue Code of 1939 did not contain any specific provisions with respect to original issue discount. The relevant statutory sections, therefore, are merely § 22, which included "interest" in its general definition of "gross income," and § 117, which provided for capital gains treatment upon the sale or exchange of a "capital asset."

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The relevant facts in this case are the free from dispute. Thus, the plaintiff's amended complaint reveals that during the taxable year 1952, the taxpayers or their spouses or decedents were partners in the investment firm of Carl M. Loeb Rhoades & Co., a member of the New York and American Stock Exchanges. At various times during the year, the partnership purchased thirty-three short-term, non-interest-bearing notes, either directly from the obligor corporation, or through agents or dealers. The notes bore maturity dates ranging from 190 to 272 days from the date of issue, and all were issued at discounts, which varied between $23\frac{3}{8}\%$ and $33\frac{3}{4}\%$ of face value. At the close of the taxable year, only thirteen notes remained on hand and unmatured; the remaining twenty had been sold during the year—all more than six months after they had been purchased.

In preparing their income tax returns for 1952, each partner reported as a long-term capital gain his distributive share of the profits realized upon twenty notes that had been sold, and no account was taken of the thirteen which remained on hand. Rejecting these computations, the Commissioner determined deficiencies totalling some \$369,-329.65. In place of the taxpayers' method of analysis, he computed the income earned by virtue of the discount for each day that each of the thirty-three notes were held by the partnership. This earned discount per day was then multiplied by the number of days that the notes were held, and the resulting amount was considered as earned interest, and afforded ordinary income treatment. Having paid the deficiencies assessed, the taxpayers brought this action for a refund.

On cross-motions for summary judgment below, Judge Levet found that the Commissioner had properly interpreted the relevant provisions of the 1939 Code, in viewing the profit derived from the discount as equivalent to interest

Appendix A—Opinion of Court of Appeals

income, and accordingly taxing it at ordinary income rates. Although recognizing that § 1232 of the Internal Revenue Code of 1954 specifically provides for ordinary-income treatment in original issue discount situations, he concluded that this section was merely intended to clarify the existing law, rather than representing an abrupt departure from the earlier practice. As a result, Judge Levet awarded judgment to the Commissioner, and the taxpayers have brought this appeal.

We should note at the outset that a narrow issue is presented for our decision. It is the taxpayers' contention that the original issue discount resulted in a long-term capital gain, which could only be realized on the twenty notes which were sold; the Commissioner, on the other hand, asserts that the discount produced interest income which must properly be computed for the period that all of the notes were held by the partnership. This dispute as to whether capital gains or ordinary income treatment was appropriate, moreover, is the only issue that divides the parties. Thus, no question has been raised as to the propriety of taxing the individual partners for notes held by the partnership, and the taxpayers have conceded that if the discount *did* represent ordinary income, that income was realized upon each of the thirty-three notes held, and was not dependent upon a sale.

Turning, then, to the single question in dispute, we find the approach adopted by the Commissioner and upheld below to be plainly correct. Indeed, unless form rather than substance is to carry the day, such a conclusion seems inescapable in light of the facts here conceded. Thus, we are aware of no meaningful distinction, and the taxpayers have offered none, between the discount income involved here and the more traditional forms of "interest on indebtedness," defined in *Deputy v. duPont*, 308 U. S. 488, 498 (1940), as "compensation for the use or forbearance of

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money." Whatever superficial or mechanical differences in form, both are designed to accomplish the same objective—the production of income for "the hire of money." And this factual identity between discount income, as employed here, and interest income seems both crucial and apparent. In the terms of an illustration offered by the Commissioner, there should be no distinction for tax purposes between a case in which \$10,000 is advanced by a lender in exchange for a \$10,000 note, payable in one year with interest at 6%, and the original issue discount situation, in which the same \$10,000 would be loaned in exchange for a note in the face amount of \$10,600. When these transactions are reduced to their essentials, it becomes plain that in both cases, the lender has advanced \$10,000, and has received that amount in return, plus \$600 in interest. It would seem arbitrary to insist, as do the taxpayers, that significant tax consequences should hinge upon whether this \$600 sum is separately stated as interest or is included in the face amount of the note. It has been repeatedly emphasized that our taxing statutes are intended to take cognizance of realities and not mere appearances or facades. See, e.g., *Commissioner v. P. G. Lake, Inc.*, 356 U. S. 260, 266-67 (1958).

Without denying the force of this reasoning, the taxpayers argue, however, that capital gains treatment is compelled by the decision in *Caulkins v. Commissioner*, 144 F. 2d 482 (6th Cir. 1944). The taxpayer there paid some \$15,043.33 over a ten-year period for an "accumulated installment certificate" which returned him \$20,000 when the certificate was redeemed. Although recognizing that the certificate was an "evidence of indebtedness" and that the increment in value represented "consideration paid for the use of the amounts paid in," the Court of Appeals for the Sixth Circuit held that the difference between the amount paid and the sum received on redemption was taxable as a long-term capital gain.

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We are willing to agree for present purposes that the notes involved here are analogous to the certificate at issue in *Caulkins*. But in light of our conclusion that original issue discount income is indistinguishable from interest income, we are of the opinion that the *Caulkins* case was wrongly decided. In so holding, we find ourselves in agreement with the greater number of courts to consider the problem. See *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir. 1959); *Rosen v. United States*, 288 F. 2d 658 (3rd Cir. 1961); *United States v. Harrison*, 304 F. 2d 835 (5th Cir. 1962), *cert. denied*, 372 U. S. 934 (1963); *Pattie v. United States*, 311 F. 2d 947 (Ct. Cl. 1963). Contra, *Midland-Ross Corp. v. United States*, 214 F. Supp. 631 (N. D., Ohio 1963). Thus, in *Jaglom v. Commissioner*, 303 F. 2d 847 (2d Cir. 1962), where we also found that a sum which actually represented interest income must be taxed as such, we noted that "before the 1954 Code specifically covered the subject, most courts held that the excess of the amount received at the maturity of a non-interest bearing note or investment certificate issued at a discount over the cost thereof, being in the nature of an interest return on the capital invested, was ordinary income." 303 F. 2d at 849.

Furthermore, we agree with Judge Levet in his conclusion that the explicit provisions for ordinary income treatment in §1232 of the 1954 Code do not require a different result with respect to pre-1954 obligations. The Senate Committee Report on §1232, indeed, evidences a clear congressional intention to clarify—rather than revise—the existing law. Thus, the Report notes that "under §117(f) of present law, when a corporate . . . bond . . . is retired the transaction is treated as a sale or exchange. There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount. (See I. T. 3486, 1941-2 C. B. p. 76, as com-

Appendix A—Opinion of Court of Appeals

pared with *Commissioner v. Caulkins*, 144 F. 2d 482). In these cases, that part of the amount received on a sale or exchange which may represent a partial recovery of discount on original issue is a form of interest income and in fact is deductible as an interest payment by the issuing corporation. Effective with respect to bonds issued after December 31, 1954, the House bill removes doubt in this area by providing that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income." 3 U. S. Code Cong. & Ad. News 1954, at 4745. (Emphasis supplied.)

We find in sum, that both reason and authority support the position adopted by the Commissioner. The taxpayers, however, urge as a final argument that the Commissioner's acquiescence in the *Caulkins* decision at the time it was rendered precludes him from taking a different position in the present case, even if we agree that ordinary income treatment was proper. We find this contention to be entirely without merit. The Supreme Court has noted that "the doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law." *Automobile Club of Michigan v. Commissioner*, 353 U. S. 180, 183 (1957). It would seem unduly harsh to hold that a mistaken interpretation of law by the Commissioner of Internal Revenue forever bars the United States government from correcting such an error, and subsequently collecting the taxes rightfully due.

The judgment is affirmed.

Opinion of Levet, D. J.

(Tr. pp. 223-238)

UNITED STATES DISTRICT COURT**SOUTHERN DISTRICT OF NEW YORK****LEVET, D. J.:**

These are cross-motions for summary judgment in an action for refund of federal income taxes paid by the plaintiffs for the taxable year 1952 in the sum of \$369,329.65 plus interest. Jurisdiction is based upon 28 USC §1346(a). The parties agree, except for one fact, which will be dealt with later, that there are no issues as to any material facts.

The facts surrounding this claim for refund are as follows.

During the year 1952, the plaintiffs were partners in the investment firm of Carl M. Loeb Rhoades & Co. (hereinafter "partnership"), a member of the New York and American Stock Exchanges. The principal sources of income of the partnership are from commissions earned on sales of customers' securities, the underwriting and selling of securities and from trading and investing on its own account.

During 1952, the partnership acquired 33 short-term non-interest bearing notes, commonly known as commercial paper. All of the notes were issued at a discount which ranged from 23 $\frac{3}{8}$ to 33 $\frac{1}{4}$ % on the face value of the notes. The notes were purchased either directly from the issuing obligor corporation or through agents or dealers on the original date of issue. The notes had maturity dates between 190 and 272 days from the date of issue. All of these notes were either sold subsequent to six months after their purchase or were retained, unmatured, at the close of the taxable year 1952.

Plaintiffs reported the distributive share of the profit realized from the sale by the partnership of 20 of the notes during the year 1952 as long-term capital gain. The Inter-

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nal Revenue Service disallowed capital gain treatment and computed the discount earned per day for each note by dividing the number of days between issuance and maturity into the total discount. The earned discount per day, multiplied by the number of days the notes were held during 1952, either before sale or as of December 31, was considered as "discount earned." The Internal Revenue Service treated the amount of "discount earned" as ordinary income. Deficiencies were assessed against the plaintiffs. The deficiencies were paid, a claim for refund was duly filed, and this action was thereafter commenced.

The parties differ as to the treatment which should be accorded to the original issue discounts. The plaintiffs claim that the amounts so realized are long-term capital gains, while the Internal Revenue Service held them to be interest, therefore, ordinary income. In addition, the plaintiffs urge the Commissioner of Internal Revenue's prior acquiescence in 1944 in the case of *Commissioner v. Caulkins*, 144 F. 2d 482 (6 Cir. 1944), affirming 1 T. C. 656 (1943), estops the Internal Revenue Service from now claiming that original issue discounts should be treated as interest since they relied on the Caulkins' acquiescence when they purchased the securities in 1952.

Thus, the issue is squarely before the court: Aside from any consideration of reliance or estoppel, when short-term non-interest bearing notes are purchased at a discount, is the amount of such discount when realized in the nature of interest or a capital gain?

DISCUSSION

A. STATUTES INVOLVED

There are two sections of the Internal Revenue Code of 1939 which must be considered in determining this action. They are Sections 22 and 117 (a) (1). Section 22 provides:

"§ 22. Gross income

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“(a) General definition. ‘Gross income’ includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *”

Section 117 (a) (1) provides:

“§ 117. Capital gains and losses

“(a) Definitions As used in this chapter—

“(1) Capital assets. The term ‘capital assets’ means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

“(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

“(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or real property used in his trade or business;

“(C) * * *

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"(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest [sic] at a fixed maturity date not exceeding one year from the date of issue."

B. DOES THE 1939 CODE ALLOW ORIGINAL ISSUE DISCOUNTS TO BE TREATED AS CAPITAL GAINS?

The plaintiffs rely heavily upon the case of *George Peck Caulkins*, *supra*. The *Caulkins* case involved a taxpayer who paid \$15,043.33 over a ten-year period for an accumulated installment certificate which returned him \$20,000 at the end of the ten years when the certificate was redeemed. The Tax Court and the Circuit Court of Appeals for the Sixth Circuit held that the difference between the amount paid and the amount received by the taxpayer upon redemption was a long-term capital gain. This result was achieved primarily through a peculiar application of Section 117 (f), which provided:

"(f) Retirement of bonds, etc. For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

The two courts were of the opinion that \$4,956.67 increment received by the taxpayer was a capital gain because Section 117(f) makes the amounts received by the holder on retirement of a certificate or other evidence of indebtedness capital gains. Therefore, on the basis of the *Caulkins*

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case, the plaintiffs urge that the increment as a result of an original issue discount on a note sold before maturity would result in a capital gain and not ordinary income.

C. THE CAULKINS CASE WAS WRONGLY DECIDED.

It is clear that the Courts in the Caulkins case wrongly interpreted the purpose and scope of Section 117(f). The situation which gave rise to the enactment of Section 117(f) is illustrated by the case of *Fairbanks v. United States*, 306 U. S. 436 (1939). There, the taxpayer acquired bonds at less than par value. The court held that the increment received upon the retirement of the bonds could not be considered as capital gains because the redemption of the bonds was not a "sale or exchange thereof" and the statute defined a capital gain as meaning "taxable gain from the sale or exchange of capital assets." Following the Fairbanks case Section 117(f) was enacted.

It seems plain that Section 117(f) was not designed to accomplish any other purpose but to reverse the type of result achieved in the Fairbanks case. Nowhere in the text of Section 117(f) or in its legislative history is there any indication that if, upon retirement of such bonds, the increment a taxpayer receives would be converted into capital assets or treated as capital gains.

The literal language of Section 117(f) if applied to facts identical to those in the Caulkins case, *supra*, yields only one conclusion, the increment should be treated as ordinary income. The operative words of Section 117(f) are: "Amounts received by the holder upon retirement . . . shall be considered as amounts in exchange therefor." In a Caulkins-type fact situation, we have a combination of both a capital asset (the notes or other evidence of indebtedness) and the interest on other earnings from that asset. The courts in Caulkins failed to realize that the gain realized from the deemed sale of a capital asset which

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has appreciated in value is capital gain, whereas, gain realized by income from the capital asset is ordinary income. The court, in other words, considered both the capital asset and the increment by way of interest or discount together and considered the combined amount as a capital gain.

The rationale of the Caulkins case has been repudiated in recent years by other courts which had cases similar to Caulkins. See *Commissioner v. Morgan*, 272 F. 2d 936 (9 Cir. 1959); *Rosen v. United States*, 288 F. 2d 658 (3 Cir. 1961); *United States v. Harrison*, 304 F. 2d 835 (5 Cir. 1962), cert. denied 372 U. S. 934 (1963); *Pattiz v. Commissioner*, 311 F. 2d 947 (Ct. Cl. 1963); *Richard B. Gibbons*, 37 T. C. 569 (1961); *V. David Leavin*, 37 T. C. 766 (1962).

THE PLAINTIFFS' CLAIM OF RELIANCE UPON
THE CAULKINS ACQUIESCENCE

The plaintiffs claim that they relied on the Caulkins case and the acquiescence in Caulkins by the Treasury Department when they entered into these transactions in 1952. Since Caulkins has been repudiated by the Commissioner, the plaintiffs contend that to apply this change of position to them would cause them substantial injury.

The law is clear that the Commissioner of Internal Revenue can retroactively correct a mistake of law even where a taxpayer has relied on the previous determination to his detriment. *Manhattan General Equipment Co. v. Commissioner*, 297 U. S. 129 (1936); *Helvering v. Reynolds*, 313 U. S. 428 (1941); *Automobile Club of Michigan v. Commissioner*, 353 U. S. 180 (1957); 10 Mertens, *Law of Federal Income Taxation* § 60.16 (Zimet Rev. 1958). Therefore, it is clear that plaintiffs' alleged reliance, even if proved, does not estop the Commissioner from apply-

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ing the correct legal principles in determining the income of the partnership. Therefore, we deem it unnecessary to pass upon this claim of reliance.

Assuming, arguendo, that the law would allow the claim of reliance, this court cannot agree with the plaintiffs that they have any ground to base their reliance upon the Caulkins decision and the acquiescence by the Commissioner. A thorough examination of the prior Treasury Department rulings demonstrates that the result reached in Caulkins was an exception to the general policy of the Internal Revenue Service to treat amounts received by original issue discount as income. Also, the prior rulings demonstrate that Caulkins is distinguishable from the present claim on the law and on its facts.

In 1940, G. C. M. 21890, 1940-1 Cum. Bull. 85 was issued. There, the Commissioner held that the amount of an original issue discount upon a state obligation was in the nature of deferred interest, therefore, non-taxable income to the taxpayer under Section 22(b)(4) of the Revenue Act of 1938, which provided for the exclusion from gross income and exempted from taxation interest upon state obligations.

In 1941, I. T. 3486, 1941-2 Cum. Bull. 76 was published. It provided that since the Public Debt Act of 1941 provided that the interest upon, and gain from sale or other disposition of, United States Treasury Bills issued on or after March 1, 1941 are no longer tax exempt, the amount of discount " . . . is includible in gross income as interest"

After Caulkins was affirmed by the Sixth Circuit, the Treasury Department acquiesced in its result. (See list of acquiescences in 1944 Cum. Bull.)

In 1953, the Commissioner published Rev. Rul. 119, 1953-2 Cum. Bull. 95. Rev. Ruling 119 provided:

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"What included in gross income

"The discount at which a 'Twelve Year Dollar Savings Bond' of the State of Israel is originally issued constitutes interest which is taxable as ordinary income under section 22(a) of the Internal Revenue Code when realized upon redemption; it does not represent an amount received upon retirement of the bond within the meaning of section 117(f) of the Code.

"Since about 1920, discount realized on retirement of State and municipal obligations in the hands of the original purchaser has been treated by the Bureau as interest, the theory being that the discount is an amount paid in lieu of interest. * * * The position taken by the Bureau * * * has been consistently maintained with regard to characterizing discount as interest and treating the excess over discount (and ordinary interest, if any) realized upon retirement as taxable income. However, after the enactment of section 117(f) of the Internal Revenue Code, the excess over discount has been consistently taxed as capital gain rather than ordinary gain (See G. C.M. 21890, C.B. 1940-1,85) Therefore, only the excess of the amount realized from a State or municipal bond, less discount from the date of acquisition, and ordinary interest, if any, over the cost or other basis of the bond is the amount received upon retirement taxable as capital gain under section 117(f) of the Code.

"In the case of Commissioner v. George Peck Caulkins, 144 Fed. (2d) 482, affirming Tax Court decision, 1 T.C. 656, acquiescence, C.B. 1944, 5, the Court held that the excess of the amount received by the taxpayer, pursuant to a contract with In-

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vestors Syndicate over the aggregate payments made by him for an Accumulative Installment Certificate, constituted capital gain and stated that the certificate in question "was an evidence of indebtedness" similar to a bond or debenture and hence falls within the statutory group governed by section 117(f). The decision should be limited precisely to what was there decided under the particular facts of that case. It would be inappropriate to apply the decision to any other case unless the facts and circumstances conform to those stated in the published decision of the Tax Court in the Caulkins case."

In 1955, Revenue Ruling 55-136, 1955-1 Cum. Bull. 213 was published. It provided:

"Section 117(f) of the Internal Revenue Code of 1939 applies only to amounts received by reason of redemption of bonds. It does not apply to the amount of interest (whether paid in the form of discount or not) which is received by reason of holding the bond. Such interest-equivalent payments are taxable as ordinary income under section 22(a) of the code.

. . .

"It has been the policy of the Internal Revenue Service to restrict the application of the Caulkins case to cases involving the identical facts. This position has been reconsidered in the light of Revenue Ruling 119, supra, i.e., that the amount received upon the redemption of a bond which represents original or initial discount constitutes interest which is taxable as ordinary income. There is no logical basis in fact or in law to distinguish the discount element in the Accumulative Installment Certificate involved in the Caulkins case from the original dis-

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count element involved ordinarily in the issuance of any bonds."

It is clear that Caulkins was an exception to the rule that amounts received from original issue discounts were treated as ordinary income. In order for the plaintiffs to rely on Caulkins it is also clear that their claim must fall into the identical exception Caulkins created. Caulkins involved a peculiar application of Section 117(f), Internal Revenue Code of 1939, to redemption of "Accumulative Installment Certificates." Here, Section 117(f) does not apply since we have a sale before maturity and not a redemption. Therefore, the exception created by Caulkins is not precedent for the claim of plaintiffs.

In *Midland-Ross Corp. v. United States*, 214 F. Supp. 631 (N.D. Ohio 1963), cited by the plaintiffs, the court rejected the distinction between the tax consequences of a sale and that of a redemption. The court stated, 214 F. Supp. at 631: "The combination of the Caulkins case with Section 117(f) thus indicates that appreciation realized on evidences of indebtedness, issued at an original issue discount and sold before maturity, constituted a capital gain and not regular income. The remaining question, therefore, is whether the legislative, administrative and judicial treatments of discount obligations support this indication." The court concluded "• • • while it is true that the recent cases have adopted the Government's position, they have done so (1) without a discussion of the historical treatment of gains resulting from original issue discount, and (2) only upon a rejection of the Caulkins case, which is controlling in this Circuit."

I cannot agree with the court in *Midland-Ross*, *supra*, that the legislative, judicial and administrative treatments support the conclusion that increments by way of original issue discounts on bonds sold before maturity must be

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treated as capital gains. Moreover, the Caulkins case does not support the court's conclusion for two reasons. First, on its facts it was wrongly decided; second, assuming Caulkins was correct, it provides no precedent for cases concerning the sale before maturity of original issue discount bonds.

In sum, it is clear that (1) Caulkins was wrongly decided; (2) even assuming Caulkins had been correctly decided, it provides no precedent for the plaintiffs; and (3) the plaintiffs cannot estop the government on the basis of the Caulkins acquiescence.

The plaintiffs' claim for refund is narrowed to a single question: What is the tax treatment accorded to increments received from short-term, non-interest bearing notes issued at a discount? The answer is clear; that portion of any profit realized upon a subsequent sale of the notes which is attributable to the discount as well as any discount earned upon unsold notes is taxable as ordinary income and not capital gain.

Substance, reality and total effect of a particular transaction will determine the tax consequences thereof. *Commissioner v. P. G. Lake Inc.*, 356 U. S. 260, 266 (1957). The forms or method of accounting for a transaction do not control, since "Their essence is determined not by the subtleties of draftsmanship but by their total effect. See *Helvering v. Clifford*, 309 U. S. 331; *Harrison v. Schaffner*, 312 U. S. 579." 356 U. S. at 266-67. In other words: "The law is not to be hoodwinked by colorable pretenses. It looks at truth and reality, through whatever disguise it may assume." *Commonwealth v. Hunt*, 45 Mass. 111, 129 (1842).

The "total effect" of the transactions which the partnership entered into makes it clear that the partnership earned interest, ordinary income as a result of these discounts. The term "interest," as contained in the "gross

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income" definition contained in Section 22(a), Int. Rev. Code of 1939, is defined as the amount which one has contracted to pay for the use of borrowed money. *Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552, 560 (1932); *Commissioner v. Morgan*, 272 F. 2d 936, 939 (9 Cir. 1939); *Jaglom v. Commissioner*, 303 F. 2d 847, 850 (2 Cir. 1962). Although it is true that there may be some valid distinctions between interest and discounts, these distinctions are of little significance. A discount is in the nature of deferred interest which may be amortized, for income tax purposes, over the life of the bonds. The Internal Revenue Service in computing the plaintiffs' tax liability did properly accrue their interest ratably over the period it was earned. 2 *Mertens, Law of Federal Income Taxation*, § 12.95, p. 276 (Zimet Rev. 1958); *Continental Tie & Lumber Co. v. United States*, 286 U. S. 290 (1932); *United States v. Anderson* 269 U. S. 422 (1926).

The plaintiffs contend that the enactment of Section 1232, Int. Rev. Code of 1954, which treats increments from discounts as ordinary income, did effect a change in the laws governing the tax treatment of original issue discounts. This contention is without merit. As stated in *Commissioner v. Morgan*, 272 F. 2d 936, 941 (9 Cir. 1959):

" * * * Respondents argue that by making this new provision for bonds issued in the future, Congress recognized that it effected a change and thereby recognized that the law previously was settled by the *Caulkins* decision. We think not. The Senate Report which accompanied the legislation (S. Rep. No. 1622, 83d Cong., 2d Sess. p. 112; 3 U. S. C. Cong. & Adm. News 1954, 4621, 4745), noted that there was 'some uncertainty as to the status of proceeds in these transactions. * * * The House bill removes doubt in this area.' We find here no evidence that the new enactment did any more than that."

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The plaintiffs also contend that even if the original issue discount is taxable as ordinary income, the Internal Revenue Service erroneously accrued the income from the notes not sold by the partnership during the taxable year 1952. While the plaintiffs concede the partnership was on the accrual basis, they assert that the notes were really individual investments of the taxpayers and not the property of the partnership and, hence, interest may not be accrued since the partner taxpayers were on the cash basis. The taxpayers state that there is an issue of fact as to the method of accounting utilized in these investments since they state they used a cash rather than accrual basis. Therefore, they contend that none of the proceeds from the notes that were not sold or redeemed in 1952 should be included in the computation of the 1952 income of the partners.

The claim for refund as well as the complaint filed herein (paragraphs 17(e) and (f)) allege that the securities were partnership property. There is no doubt that the partnership tax return was computed on the accrual basis in 1952. Therefore, the unsupported allegation in plaintiffs' statement pursuant to Rule 9(g) of the General Rules of the United States District Court for the Southern District of New York to the effect there remains a genuine issue of fact as to the method of accounting will not prevent the grant of complete summary judgment to the government. As Rule 56, Fed. R. Civ. P. makes clear: "When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon mere allegations or denials of his pleadings, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial." This the plaintiffs have not done. Since this is a refund action the plaintiffs must not only demonstrate that the Commissioner's method of computation is wrong but also must establish the actual and precise method of

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computation which should have been utilized. *Taylor v. Commissioner*, 70 F. 2d 619, 620-21 (2 Cir.), aff'd 293 U. S. 507 (1935); *Alvary v. United States*, 302 F. 2d 90 (2 Cir. 1962).

Accordingly, the plaintiff's motion for summary judgment is denied and the defendant's motion for summary judgment is granted with costs.

Settle judgment on notice.

Dated: New York, N. Y.
November 1, 1963

RICHARD H. LEVET,
United States District Judge.

(Statutes Involved)

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. (26 U.S.C. 1952 ed., Sec. 111)

Sec. 117. Capital Gains and Losses.

(a) Definitions—As used in this chapter—

(1) Capital Assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

Statutes Involved

• • •
(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

• • •
(2) **Short-Term Capital Gain.**—The term “short-term capital gain” means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income;

• • •
(4) **Long-Term Capital Gain.**—The term “long-term capital gain” means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

• • •
(f) **Retirement of Bonds, etc.**—For the purpose of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

(26 U. S. C. 1952 ed., Sec. 117)

APPENDIX B**(Conflicting Opinions)**

No. 15524

**UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT**

MIDLAND-ROSS CORPORATION,*Plaintiff-Appellee,*

v.

UNITED STATES OF AMERICA,*Defendant-Appellant.*

ON APPEAL from the
United States Dis-
trict Court, North-
ern District of Ohio,
Eastern Division.

Decided July 29, 1964.

Before: WEICK, Chief Judge, CECIL, Circuit Judge,
and McALLISTER, Senior Circuit Judge.

PER CURIAM. This cause is before the Court on appeal from a judgment of the United States District Court for the Northern District of Ohio granting judgment in favor of the appellee, a taxpayer, against the United States, the appellant. The sole question presented on the appeal is whether original discount income received upon the sale of notes prior to their maturity is entitled to be treated as

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capital gains under Section 117(f) of the Internal Revenue Code of 1939.

Judge Kalbfleisch of the District Court wrote a comprehensive opinion in the case in which he followed the ruling of this Court in *Commissioner of Internal Revenue v. Caulkins*, 144 F. 2d 482. While some courts¹ have taken a contrary view on the issue presented we are of the opinion that the *Caulkins* case, controlling in our circuit, was correctly decided.

The pertinent facts are stated in the opinion of the District Court reported at *Midland-Ross Corp. v. United States*, 214 F. Supp. 631. We agree with the opinion of Judge Kalbfleisch and the judgment of the District Court is affirmed.

¹ *Dixon v. United States*, — F. 2d —, C.A. 2; *Pattitz v. United States*, 311 F. 2d 947, Ct. Cl.; *United States v. Harrison*, 304 F. 2d 835, C.A. 5, cert. den., 372 U.S. 934; *Rosen v. United States*, 288 F. 2d 658, C.A. 3; *Commissioner v. Morgan*, 272 F. 2d 936, C.A. 9.

Appendix B—Conflicting Opinions

UNITED STATES DISTRICT COURT

N. D. OHIO, E. D.

Civ. A. No. 36611.

March 11, 1963.

MIDLAND-ROSS CORPORATION,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

KALBFLEISCH, District Judge.

This is a suit to recover income and excess profits taxes for the years 1952, 1953 and 1954. The taxpayer is the Midland-Ross Corporation, successor in interest to the Industrial Rayon Corporation. During the period in question, for the purpose of temporarily investing funds not then currently required for its operation, the taxpayer purchased thirteen notes, the face amounts of which varied from \$500,000 to \$2,000,000. These notes bore no interest, but rather were purchased at a discount by the taxpayer from the maker. Each of the notes was a time instrument.

Before maturity each note was sold to a financial institution at a price which was in excess of the price which had been paid to the maker but below the face amount.

The price paid by the taxpayer to the maker of each note was calculated by subtracting from the face amount a figure determined by multiplying the face amount by an agreed percentage, dividing the product by 360, and multiplying the result by the number of days from the date of such payment to the maturity of the note. The agreed percentage was determined on the basis of the considera-

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tion of several factors, including (1) the prevailing interest rates for notes of such duration made by borrowers with credit standings of the obligor, (2) the availability of such notes to prospective purchasers, and (3) the maker's need for cash funds. All of the notes were capital assets in the hands of the taxpayer and were sold by it in bona fide sales. In negotiating the sale price of the notes, the following factors were considered: (1) the face amounts of the obligations, (2) the credit rating of the obligor, (3) the period of time between the sale and the maturity of the notes, (4) the prevailing interest rates, and (5) the amount of cash funds available to the purchaser.

In this three-year period the taxpayer realized a total appreciation of more than \$280,000 on these notes. It contended that this appreciation was a capital gain, while the Internal Revenue Service contended that it was regular income. The taxpayer paid taxes at the regular income rate, and is here seeking a refund.

The relevant sections of the Internal Revenue Code are: Section 117(a) (1) (2) and (4) and Section 111(a) of the 1939 Code, and their counterparts in the Code of 1954.

Section 117(a) (1) of the 1939 Code defines a capital asset as:

“ * * * property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *

“(D) an obligation of the United States or of any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.”

Subsections (2) and (4) of Section 117(a) provide that a capital gain is a gain from the sale of a capital asset,

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and Section 111(a) provides that the gain from the disposition of property is the "excess of the amount realized therefrom over the adjusted basis"

Plaintiff stresses the fact that the language of the statute, especially of Section 117(a) (1) defining a capital asset, is broad and sweeping. It contends that because these notes were capital assets the gain realized thereon was a capital gain. It contends, further, that in view of Section 117(a) (1) (D), which specifically excludes certain types of discount paper from the category of capital assets, and in view of the failure to exclude such paper as these notes, the Congress clearly indicated its intention that the gain achieved on the sale of such notes constitutes capital gain under the maxim of *expressio unius est exclusio alterius*.

[1] The taxpayer's contention is a familiar enough general rule of statutory construction. However, various courts have read certain exceptions into this statute. They have held that, while it might appear that a literal construction of the statutory language would convert all but the specifically excluded gains into capital gains, the provisions must be construed in the light of their general purpose and the surrounding law. After so doing, these courts have read further exceptions into the statute, which have resulted in the exclusion from capital gains treatment of certain increments which a literal interpretation might indicate were capital gains. See, for example, *Jaglom v. Commissioner*, 303 F. 2d 847 (2nd Cir., 1962); *United States v. Harrison*, 304 F. 2d 835 (5th Cir., 1962). In view of the fact that these statutory sections have not been interpreted to include all of the transactions which the sweeping scope of their language might indicate were within their purview, the Court is constrained to hold that this argument is not dispositive of the case.

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The Government contends that the realized increment was in fact interest paid for the use of money, and was therefore regular income to the taxpayer. It contends that this is but another instance for application of the well recognized rule that when a taxpayer combines the sale of a right to receive ordinary income with the sale of a capital asset the ordinary income is not converted into a capital gain by its sale in combination with the capital asset. *Fisher v. Commissioner*, 209 F. 2d 513 (6th Cir., 1954), cert. den. 347 U. S. 1014, 74 S. Ct. 868, 98 L. Ed. 1136; *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir., 1959); *Rosen v. United States*, 288 F. 2d 658 (3rd Cir., 1961); *United States v. Harrison*, 304 F. 2d 835 (5th Cir., 1962); and *United States v. Langston*, 308 F. 2d 729 (5th Cir., 1962).

† The taxpayer does not dispute the general validity of this proposition. Its principal contention, however, is that the rule is inapplicable on these facts because the increment, for purposes of taxation at least, was not interest. It fully admits that if these notes had borne interest at a stated rate, and if it had then sold such notes before maturity at an increase in price, the amount of such increase allocable to the proportion of the interest earned to the date of sale would have been regular income under the rule of *Fisher v. Commissioner* and the other cases cited, *supra*. However, it contends that a different result is achieved when, instead of the notes bearing interest at a fixed rate, they were originally sold at a discount. The taxpayer urges that there has been a continuous history of legislative, administrative and judicial interpretation since 1920 which has consistently held that original issue discount in the hands of a cash basis taxpayer is not income, and that the appreciation resulting therefrom is not taxed as regular income but, rather, as a capital gain.

[2] If it is true that historically the law has not considered such original issue discount as interest, but has

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removed it from the broad category of regular income and placed it within the specific classification of capital gain, then the increment in this case was not income and the general rule upon which the Government relies is inapplicable. The Court, therefore, must proceed to examine the treatment which such discount has traditionally received.

Commissioner v. Caulkins, 144 F. 2d 482 (6th Cir., 1944) is the primary cornerstone upon which the taxpayer rests its contention that the increment here involved was not, for taxation purposes at least, compensation for the use of its money. In that case the taxpayer had purchased an accumulative installment certificate under the terms of which he was to make periodic payments to the seller, who, at the end of ten years, would pay to the taxpayer the sum of \$20,000. This \$20,000 was approximately \$4,900 more than the total amount of the payments made to the seller. The Commissioner contended that this \$4,900 was compensation for the use of the taxpayer's money, and was thus really interest. He held that this interest was regular income, although the taxpayer contended it was a capital gain.

The certificate involved in the *Caulkins* case was in registered form and the decision was based upon an interpretation of Section 117(f) of the Internal Revenue Code of 1939. Section 117(f) provided that amounts received by the holder of registered securities upon their retirement should be considered as amounts received in exchange therefor. The Court held that although the \$4,900, at least in many respects, was similar to interest, it was an amount which was received in exchange for the sale of a capital asset and was therefore a capital gain.

To understand the *Caulkins* decision it is necessary to understand the history of Section 117(f). Before the enactment of that section it had been held that retirement of a bond was not such a sale or exchange as would qualify the amount received upon the retirement for capital gains

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treatment. See *Fairbanks v. United States*, 306 U. S. 436, 59 S. Ct. 607, 83 L. Ed. 855 (1939). Section 117(f) was enacted to avoid this holding. It provided that amounts received upon the retirement of certain evidences of indebtedness which had interest coupons attached, or which were in registered form, should be considered as amounts received in exchange therefor. This provision enabled the amounts received upon the retirement of such bonds to qualify as capital gains. The taxpayer contends that this provision was enacted to accord the same tax treatment to such bonds upon their retirement as always had been accorded them on a sale before retirement. And, according to Mertens Law of Federal Income Tax, Volume 38, page 368, M 82:

“The purpose underlying the enactment of Section 117(f) of the 1939 Code was to accord to the retirement of obligations similar treatment as was then, and is now, accorded to their sale or exchange.”

In view of the purpose of Section 117(f), it appears that before the passage of that section amounts received upon the sale of such evidences of indebtedness did qualify for capital gains treatment. If a sale before maturity of such obligations did not permit increments to be accorded capital gains treatment, it is unlikely that the Congress would have deliberately enacted a provision according them such favorable treatment upon retirement.

From the combination of this legislative history with the *Caulkins* decision it is possible to draw the following analogy: Section 117(f), under the *Caulkins* holding, provided that all amounts received in exchange for the retirement of a qualifying capital asset were capital gains. Because Section 117(f) was meant to be declaratory of the pre-existing law on sales before retirement, it follows that all amounts received on the pre-retirement sale of such debt obligations were likewise capital gains. The validity

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of this analogy must be tested by a further inquiry into legislative, administrative and judicial history. However, before proceeding with that history it is necessary to examine the Government's position as to what the *Caulkins* case really held.

The Government contends that *Caulkins* was based solely upon an interpretation of Section 117(f). It says that the crucial fact in *Caulkins* was not that the debt obligations were discount obligations but that a retirement rather than a sale was involved. It has thus attempted to convince the Court that the *Caulkins* decision does not control this case, because in the present instance the notes were sold before maturity, rather than retired. It is true that the opinion in the *Caulkins* case primarily discusses the retirement factor; however, the Court is not convinced that increments on debt obligations, which qualify under Section 117(f) would be accorded capital gains treatment if the obligations were retired, but would be taxed at regular income rates if they were sold before maturity. Even the Tax Court, which adopted that position in *Paine v. Commissioner*, 23 T. C. 391 (1954), Rev. 236 F. 2d 398 (8th Cir., 1956), and *Stanton v. Commissioner*, 34 T. C. 1 (1960), has now abandoned such a distinction. *Gibbons v. Commissioner*, 37 T. C. No. 57. The purpose of Section 117(f) surely was not to accord a more favorable tax treatment to income realized upon retirement of debt obligations than it would receive if they were sold before maturity. The quotation from *Mertens, supra*, also clearly indicates that such was not the case. Therefore, this Court is constrained to hold that the crucial fact in the *Caulkins* case was that the evidences of indebtedness were discount obligations.

The combination of the *Caulkins* case with Section 117 (f) thus indicates that appreciation realized on evidences of indebtedness, issued at an original discount and sold

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before maturity, constituted a capital gain and not regular income. The remaining question, therefore, is whether the legislative, administrative and judicial treatments of discount obligations support this indication.

The earliest administrative decision upon this matter which has been furnished to the Court is Office Decision 1024 published in Vol. 2, Cum. Bul. 189 (1920), holding that original issue discount on bonds was not interest and, therefore, was not subject to special withholding provisions when the bonds were in the hands of foreign corporations. It is true, as the Government contends, that this opinion was not concerned with whether an appreciation resulting from such discount was a capital gain or regular income. It was concerned, however, with whether such gain was in fact interest. The opinion carefully examined the various factors involved and came to the conclusion that original issue discount, while in some ways like interest, differed from interest in other respects and was in fact not interest.

The writers appear to have been agreed that in the period following 1920 a taxpayer could not accrue bond discount, but had to report all of it in the year in which it was received. No part of the discount was allowed to be treated as income prorated over the life of the bond. See Accountant's Handbook, 2d Ed., p. 339 (1932); Newlowe, Intermediate Accounting, p. 205 (1939); and 4 Mertens Law of Federal Income Taxation, Section 23.162, p. 298. However, this well established rule does not meet the real issue in question, which is whether the income, in the year in which it was reported, was treated as a capital gain or as regular income. There is, however, one case from this period which again reiterates the fact that discount is not interest. That case is *Corn Exchange Bank v. Commissioner*, U. S. Board of Tax Appeals, 6 B. T. A. 158 (1927). Taxpayer had sought to amortize bond discount and premium. The Board of Tax Appeals

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refused to allow such amortization. In doing so, it said, at page 161:

“The discount on the bond purchased below par is unlike interest, which is a fixed charge and accrues periodically. The right to receive this discount, or difference between the cost of the bond and its par, cannot be determined in advance as the bond may be sold for more or less than its cost, or, perhaps, as in the case of many bonds, it may be redeemed prior to its maturity at an amount different from its principal or face amount of the bond. This discount is not earned or accrued in annual installments and cannot be income to the holder of the bond, either as additional interest or as a separate item of income.”

The Government contends that the *Corn Exchange Bank* opinion was dealing only with regular discount as distinguished from original issue discount. It fully agrees that discount which is the result of such factors as an obligor's default in interest payments does not give rise to ordinary income. However, an examination of both the facts and the opinion in the *Corn Exchange Bank* case fails to reveal that the Court there was discussing any particular kind of discount. A practical examination of the transactions involved leads the Court to conclude that it is extremely likely that both kinds of discount were involved.

This case indicates that during the 1920's the Department of Internal Revenue, which prevailed in the *Corn Exchange Bank* decision, had contended that discount was not interest. And if discount was not interest, income resulting from discount could not have been taxable at regular rates on the premise that it was interest.

In 1940 the Internal Revenue Service held that income realized from the redemption of state discount bonds was

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interest, and, accordingly, was non-taxable. G.C.M. 21890, 1940-1, Cum. Bul. 85. It said the courts had considered the nature of discount and found it to be like deferred interest. Such discount was, in effect, payment for the use of the money lent. The value of this ruling is questionable, however, because it necessarily involved statutory and constitutional limitations upon the federal taxation of state bonds. And while the ruling held that such discount was like interest, it carefully avoided holding that it was interest. Thus, at least until 1940, and possibly thereafter, the Internal Revenue Service held that discount was not interest. The legislative treatment of bond discount should be viewed against this administrative background.

In 1929 the Congress authorized the Treasury Department to issue non-interest-bearing discount obligations. The bill authorizing these notes, as passed by the House and as approved by the Senate Finance Committee, contained a provision that, as to profits attributable to the discount, "any gain from the sale or other disposition thereof shall be exempt from all taxation." Congressional Record, Senate, June 4, 1929, p. 2319. This provision for tax exemption met with considerable opposition upon the floor of the Senate, *because the Senators believed such profits were capital gains*, and feared that such a provision would open the way for the future exemption of all capital gains from taxation. Several members of the Senate engaged in a lengthy debate about the relationship between original issue discount and interest, and the tax consequences that flowed therefrom. That debate indicates that at least some members of the Senate believed that original issue discount was in fact a substitute for interest; but those who purported to be familiar with the subject pointed out that, under the then current practice of the Bureau of Internal Revenue, income attributable to original issue discount was treated as a capital gain and not as regular income. See page 2331, Congressional Record, *supra*.

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The question was finally resolved by the insertion of a provision in the bill that amounts received as the result of original issue discount on these notes would be called interest, thus bringing them within the already existing interest exemption. Likewise, a similar provision was added as an amendment to the Second Liberty Bond Act of 1917, Title 31 U.S.C.A. § 757c(d). Thus, the legislative history indicates that appreciation resulting from this discount was statutorily transformed into interest to avoid its taxation as a capital gain.

These facts further substantiate the taxpayer's contention that during the period of the 1920's and early 1930's original issue discount was not considered interest, but rather gave rise to a capital gain. Furthermore, the Congress was aware of this construction and acquiesced therein by failing to statutorily change the rule until 1954. See Section 1232(a) (2) (A), Internal Revenue Code of 1954. This section now provides that, upon the sale or exchange of evidences of indebtedness issued by a corporation or a government, amounts of appreciation attributable to original issue discount will not be considered as gains resulting from the sale or exchange of a capital asset. In other words, in 1954, and governing evidences of indebtedness issued after the ones which are now before this Court, the Congress stated that appreciation resulting from original issue discount would henceforth be considered as regular income and not as capital gain.

The House report accompanying this section stated that under existing law such gains were taxed as capital gains if the bond was held to retirement, and that this section was enacted to change that rule insofar as appreciation resulting from original issue discount was concerned. 3 U. S. Code Congressional and Administrative News, 1954, p. 4110. The report of the Senate Finance Committee is less helpful. It merely stated that "There is some uncertainty as to the status of proceeds in these transactions,

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i. e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount * * *." 3 U. S. Code Congressional and Administrative News, 1954, p. 4745. In support of its statement that there was some confusion as to the current status of the law, the Senate report compared *Commissioner v. Caulkins* to I. T. 3486, 1941-2 Cum. Bul., p. 76. However, the Internal Revenue holding, upon which the Senate Committee relied, dealt only with a specific statutory provision which provided that such gains realized on the sale of Treasury bills should be interest. That provision had been enacted to make such gains non-taxable by bringing them within the exemption which interest enjoyed. Thus, the Senate Report does not cite any evidence of uncertainty insofar as the generally applicable principles are concerned.

At various times the Congress has enacted special provisions regarding the treatment of discount. For instance, the Internal Revenue Code of 1939, Sections 201(e) and 207(e), provided that stock and mutual life insurance companies must accrue discount.

And in 1938 the House Ways and Means Committee discussed the relationship between discount and interest. That Committee report stated:

"It is important also to emphasize that there is no clear separation, in practice, between capital gains and ordinary income; * * * *A bond purchased at a premium results in a capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain.*" Hearings on H. R. 9682, Subcommittee of Committee on Ways and Means, 75th Congress, Third Session, p. 38. (Emphasis added.)

Here again is evidence of Congressional knowledge that appreciation due to bond discount was a capital gain. The Sub-

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committee recommended that no change be made in this rule.

And again, in Section 42(b) of the 1939 Internal Revenue Code, the Congress gave taxpayers an election to treat as current income the periodic increases in redemption value of non-interest-bearing obligations issued at a discount when such obligations were redeemable for fixed amounts which increased at stated intervals.

Thus the evidence indicates that the Congress clearly believed that appreciation resulting from original issue discount was a capital gain. With this knowledge Congress adopted various pieces of specific legislation providing for special treatment of discount in certain specified situations. However, Congress took no action to change the general law. These facts indicate a Congressional intention, until 1954, that capital gains treatment continue to be accorded to gains resulting from bond discount. And there was no indication of any thought that different treatment should be given to gains resulting from original issue discount than was accorded those resulting from other types of discount.

Both parties have cited various explanations and public policies underlying the special treatment which the Congress has accorded to capital gains. As the Government has indicated, there are several reasons for this special treatment. However, even the Government cannot deny that one important reason is to avoid taxing, at unusually high rates, income which has in fact been earned over a number of years but which is realized only in the year of sale. In other words, the accumulation of income actually accrued over a period of years, but realized only in the year of sale, which is inherent in the profitable sale of most capital assets, would, under our system of highly progressive income taxation, result in a taxation of such income at far higher rates than would have been the case if the income had been reportable in each of the years in which it accrued but was not realized. The capital gains

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provisions place a limit upon the extent to which such gains can be taxed. In view of this purpose, it certainly appears that the long-term appreciation, resulting from original issue discount of bonds and other evidences of indebtedness, can be appropriately fitted within that category of appreciation which is accorded the special capital gains treatment.

In several instances the Tax Court has had occasion to consider the proper method of taxing gains resulting from original issue discount. It must be remembered that in the Corn Exchange Bank case, *supra*, the Board of Tax Appeals held that discount was not interest. The next occasion on which the Court was faced with the problem was in *Caulkins v. Commissioner*, 1 T. C. 656 (1943), where it decided that original issue discount gave rise to a capital gain and not to regular income. It was this opinion which was affirmed by the Sixth Circuit in *Commissioner v. Caulkins*, *supra*.

In 1954, on a complex factual situation, it held that discount was really interest and therefore gave rise to regular income when the securities were sold before maturity. *Paine v. Commissioner*, 23 T. C. 391 (1954). That holding was reversed by the Eighth Circuit in *Paine v. Commissioner*, 236 F. 2d 398 (1956). While it cannot be said that the Eighth Circuit held that discount resulted in a capital gain, that Court did hold that the appreciation involved in the *Paine* case was not interest. The language of the Court further indicates, however, that it did not think that discount created gains which were taxable as regular income.

Another case before the Court was *Commissioner v. Morgan*, 30 T. C. 881 (1958), involving accumulative investment certificates identical to those in the *Caulkins* case. The Tax Court held that the appreciation on these certificates was a capital gain. The Commissioner appealed that determination to the Ninth Circuit, which reversed the Tax Court. *Commissioner v. Morgan*, 272 F. 2d 936 (1959).

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The Court of Appeals considered the Sixth Circuit's Caulkins decision and refused to follow it. The Court held that Section 117(f) was designed only to allow capital gains treatment to be accorded to "true" capital gains. The Court refused to give the language of Section 117(f) the all-encompassing scope that it had been accorded by the Sixth Circuit.

The Tax Court reaffirmed its holding that such gains were capital gains in *Goodstein v. Commissioner*, 30 T. C. 1178 (1958). And it was again faced with another of the Caulkins-type accumulative investment certificates in *Kormendy v. Commissioner*, 18 T. C. M. 353 (1959). This case was decided after *Morgan* but before the reversal of *Morgan* by the Ninth Circuit. Again, the Tax Court affirmed its *Morgan* and *Caulkins* holdings.

Finally, in 1960, after the reversal of the *Morgan* decision by the Court of Appeals, the Tax Court again had a similar problem in *Stanton v. Commissioner*, 34 T. C. 1 (1960). In that case the taxpayer had purchased short-term Government notes and commercial paper at a discount. This paper he sold before maturity but after holding for more than six months. The excess of the amount realized over the cost was reported as a long-term capital gain. The Tax Court held that the appreciation was regular income because the notes were sold before maturity. In support of this decision the Court cited its *Paine* opinion, which it said had been reversed on other grounds.

The most recent case that it has considered was *Gibbons v. Commissioner*, 37 T. C. No. 57. In *Gibbons* the Tax Court held that discount was *always* interest, and thus regular income, no matter whether it was realized upon a sale or exchange before retirement, or upon the retirement of a debt obligation. Thus, in *Gibbons*, the Tax Court completely rejected the *Caulkins* decision, and abandoned the distinction that it had made in *Paine* and *Stanton* between gains realized on a sale and gains realized on a retirement.

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The problem of original issue discount has been considered recently by a number of constitutional courts. Most of the decisions which were cited to this Court have but again reaffirmed the validity of the general principle for which the Government contends. When the evidences of indebtedness in question were interest-bearing obligations the applicability of this proposition cannot be questioned. Cases which have dealt with the rule in such situations are: *Fisher v. Commissioner*, 209 F. 2d 513 (6th Cir., 1954), cert. den. 347 U. S. 1014, 74 S. Ct. 868, 98 L. Ed. 1136; *United States v. Langston*, 308 F. 2d 729 (5th Cir., 1962); *Arnfeld v. United States*, 163 F. Supp. 865, 143 Ct. Cl. 277 (1958), cert. den. 359 U. S. 943, 79 S. Ct. 722, 3 L. Ed. 2d 676; and *Jaglom v. Commissioner*, 303 F. 2d 847 (2nd Cir., 1962); cf. *Commissioner v. Phillips*, 275 F. 2d 33 (4th Cir., 1960). Thus, there are only five cases which actually have dealt with the treatment to be accorded to gains resulting from original issue discount. Those cases are: *Commissioner v. Caulkins*, 144 F. 2d 482 (6th Cir., 1944); *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir., 1959); *Rosen v. United States*, 288 F. 2d 658 (3rd Cir., 1961); *United States v. Harrison*, 304 F. 2d 835 (5th Cir., 1962); and *Pattiz v. United States*, Ct. Cl., 311 F. 2d 947 (1963). The Morgan and Rosen decisions were based upon the same fact situation that was presented to the Sixth Circuit in *Caulkins*. The results in the Third and Ninth Circuits were obtained by a specific rejection of the *Caulkins* decision. In neither case did the Court examine the legislative, administrative or judicial history which has surrounded the treatment of original issue discount. Instead, the Court was presented with the proposition on an almost *de novo* basis and, perhaps naturally enough in the absence of familiarity with the detailed history, fell back upon the broad, general proposition for which the Government here contends. Likewise, the Harrison and Pattiz decisions were based upon a specific rejection of *Caulkins* and on an adoption of the Morgan

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and Rosen opinions, and neither case considered the historical treatment of original issue discount. Therefore, while it is true that the recent cases have adopted the Government's position, they have done so (1) without a discussion of the historical treatment of gains resulting from original issue discount, and (2) only upon a rejection of the Caulkins case, which is controlling in this Circuit.

The following factors support the taxpayer's contention: (1) the opinions of the Department of Internal Revenue and the Board of Tax Appeals, during the 1920's and early 1930's that discount was not interest; (2) Congressional belief, expressed both in 1929 upon authorization of Treasury bills and later in the Second Liberty Bond Act, that original issue discount resulted in a capital gain, and consequent Congressional action to avoid that result; (3) the report of the Subcommittee of the Ways and Means Committee of the House of Representatives, in 1938, that discount gave rise to a capital gain; (4) Congressional enactment of various specific pieces of legislation providing that appreciation resulting from discount would be treated as other than a capital gain; (5) the failure of the Congress to take any action to change the treatment of bond discount except in regard to highly specialized factual situations; (6) the passage of Section 117(f), as interpreted by the Caulkins decision, indicating that all amounts received upon retirement, and attributable to original issue discount, were capital gains; (7) the numerous early opinions of the Tax Court that original issue discount resulted in a capital gain; and (8) the fact that none of the cases which have rejected Caulkins have considered the historical treatment of bond discount. Against these factors, and in support of the Government's contention, it is possible to infer, from several administrative rulings dealing with specific statutory situations, that bond discount was really interest and was taxable as regular income. The 1929 Senate debate and the 1938 House hearings refute any possible implication from

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other Congressional enactments that original issue discount resulted in regular income. The factors supporting the taxpayer's contention are clearly of controlling weight.

It may well be that, in financial circles at least, original issue discount is considered to be a form of interest. If this is the case, it is certainly understandable why the various courts of appeal, which have considered this question on an almost *de novo* basis, have held that original issue discount resulted in regular income to the taxpayer. It is likewise true that there has been a trend—commencing with certain legislative enactments, proceeding through some administrative interpretations, and culminating with the Congressional enactment of 1954—toward classifying appreciation resulting from original issue discount as interest. This trend began with certain very specific factual situations and expanded to include nearly all governmental and corporate evidences of indebtedness. However, careful study of this developing trend confirms the Court's belief that it has effectuated a change in the law. The facts in this case are not within any of the specific factual situations for which this change has been made and, therefore, the Court is constrained to hold that, as to the notes here in question, the appreciation for taxation purposes was not interest but, rather, an appreciation on capital, and was therefore taxable as a capital gain.

Should it be required, this memorandum will be adopted as findings of fact and conclusions of law under Section 52(a), Federal Rules of Civil Procedure.